



HOME UNDERWRITING

RENTAL

HOMEBUYER

HOMEOWNER

HOME RENTAL UNDERWRITING

JANNA CECIL, HOUSING MANAGER
CITY OF KNOXVILLE

- HUD required policies
- Review of underwriting components
- Underwriting for sustainability
- Q & A at end of session

SUBSIDY LAYERING AND UNDERWRITING REQUIREMENTS FOR RENTAL AND HOMEBUYER DEVELOPMENT PROJECTS— 24 CFR PART 92.250 AND 92.254(F)

- The PJ must adopt subsidy layering and underwriting guidelines to ensure that it does not invest any more HOME funds (alone or in combination with other funds) than are necessary to the project and to ensure that the owner's or developer's profit or return on his/her investment is appropriate and reasonable, given the size, type and complexity of the project.

THIS MUST BE CERTIFIED IN IDIS WHEN THE PROJECT IS FUNDED

WHAT IS HOME UNDERWRITING?

- The analysis of project assumptions and risks to determine if the public investment is reasonable and the project can be expected to meet all applicable program requirements during the affordability period.
- Determination of the appropriate level of HOME assistance, given the level of investment by other financing sources. (Subsidy Layering)

OTHER RELATED HOME REQUIREMENTS

- Maximum per unit subsidy limits
- HOME deadlines
- Cost allocation
- Property standards
- Written agreements
- Rents/utility allowances
- Commitment
- Affordability period

PJ'S UNDERWRITING POLICIES AND PROCEDURES

RENTAL

- PJ's must have written policies and procedures in place that are used to underwrite each project. These guidelines must include, at a minimum:
 - Examination of the sources and uses of funds and a determination that all costs are reasonable.
 - Examination of the operating pro-forma to determine that it meets the PJ's standards for reasonable rent, expense and cash flow assumptions.
 - Process to determine the appropriate level (and type) of HOME subsidy.

PJ'S UNDERWRITING POLICIES AND PROCEDURES

RENTAL (CONT'D)

- Assessment of the written financial commitments for the project.
- Assessment of the current market demand in the area where the project will be located.
- Assessment of the experience and financial capacity of the developer or owner.

WHEN DOES UNDERWRITING TAKE PLACE?

- Underwriting is a continuous process that starts with the initial funding request.
 - An analysis will be performed initially.
 - As projected costs change or initial estimates are replaced by firm bids/actual costs.
 - During construction as change orders are executed.
 - At construction completion or final draw, when final sources and uses can be verified.

SOURCES AND USES OF FUNDS

- Sources of Funds - All other funding sources must be in place before HOME funds can be committed to a project.
- Written documentation of other funding sources must be provided
 - Firm commitment letters with all terms and conditions for all mortgages, grants, bridge loans and tax credits.
 - Copy of a partnership or operating agreement, which will indicate the cash contributions by the partner(s) or member(s).
 - Evidence of available equity funds, if being provided by the developer/owner.

REVIEW OF OTHER FUNDING SOURCES

- Are funding sources adequate and timely?
- Are other funding sources compatible with HOME?
- Are the funding sources firmly committed?

USES OF FUNDS – THE DEVELOPMENT BUDGET

- Estimate of the total costs to construct or rehabilitate a residential property.
- Costs are usually grouped into various categories to show the cost of each major project component.
- Written policies should detail eligible costs and how the PJ will document cost reasonableness.
- Review the development budget against the written policies.

ACQUISITION COSTS

COSTS INCLUDE

- Actual cost of the land or the land the buildings

DEVELOPER PROVIDES

- Sales contract
- Settlement Statement

COST REASONABLENESS DETERMINATION

- As- Is Appraisal
- If sales price is higher than appraised value, developer needs to provide a solid justification that PJ approves in order to move forward.

HARD COSTS- ACTUAL COSTS OF CONSTRUCTION OR REHABILITATION

COSTS INCLUDE

- Materials & Labor
- Contingencies
- Environmental Remediation
- Site work and demolition
- Utilities
- Landscaping

DEVELOPER PROVIDES

- Bids
- Contracts
- Invoices
- Cost certification from accountant

COST REASONABLENESS DETERMINATION

- Review of comparable projects in the same area
- Consult published construction cost guides such as R.S. Means or Marshall & Swift
- Procurement or bidding process

SOFT COSTS

COSTS INCLUDE

- Architectural and engineering fees
- Appraisals, title and legal costs
- Surveys
- Market study
- Consultants
- Financing fees

DEVELOPER PROVIDES

- Bids
- Contracts
- Invoices
- Cost certification from accountant

COST REASONABLENESS DETERMINATION

- Obtain typical transaction cost information from law firms, title companies and other private sector parties
- Gather actual costs from past projects to pull together a “standard” reasonable amount
- Published cost guides

SYNDICATION COSTS FOR LIHTC PROJECTS

COSTS INCLUDE

- Legal
- Accounting
- Tax opinion

DEVELOPER PROVIDES

- Contracts
- Invoices
- Cost certification from accountant

COST REASONABLENESS DETERMINATION

- State Housing Agencies should be able to confirm if the costs are reasonable

INITIAL OPERATING RESERVES

- An Initial Operating Reserve is capitalized as part of project funding
- Established to cover the projected cash flow shortage during the lease-up period
- Amount should be reviewed based on projected expenses and length of lease-up period



THE DEVELOPER FEE

- Written policies should clearly indicate a maximum developer fee
- Developer fees should be based on the size, complexity and risk of the development.
- Take into consideration other sources of profit for developer (does developer own the construction company, etc.?).
- Typical fees are between 10% and 15%.
- A portion of the developer fee may be deferred.



OTHER CONSIDERATIONS

- Are the proposed costs sufficient to achieve all program requirements, including property standards, to provide quality housing for at least the affordability period?
- Are the costs to be paid with HOME funds eligible under the HOME rule?



OPERATING PRO-FORMA

- PJ must establish minimum criteria for the content and/or the format of the pro-forma.
- Pro-forma should extend at least as long as the Affordability Period.
- Evaluate the reasonableness of the financial assumptions by reviewing the specific line item cost and total operating cost.
- Keep sustainability guidelines in mind as you review the pro-forma.



A SUSTAINABLE DEVELOPMENT IS:

- One that is unlikely to need additional subsidy during the affordability period; and
- Can accommodate moderate “income shocks” such as an increase in vacancy rate; and
- Can accommodate moderate expense shocks such as an increase in utility cost; and
- Can self-fund its capital needs over time.

PROJECTED RENTS AND OTHER INCOME

- Rents must be based on achievable levels.
- HUD recommends setting initial rents somewhat below the HOME limits because HOME rents may not increase as rapidly as market rents.
- Vacancy rate should be consistent with local market conditions and includes physical vacancy and collections loss and meet lender requirements.
- Other income (laundry, late fees, etc.) will be modest and projected conservatively.
- The rate of projected growth should be based on local trends.

NET OPERATING INCOME

- This is the gross potential rents less the vacancy rate plus other miscellaneous income such as late fees, laundry, etc. EXAMPLE:

Gross Rents	\$90,000
Less Vacancy Rate (7%)	6,300
Net Rents	83,700
Plus Misc. Income	1,500
NET OPERATING INCOME	\$85,200

PROJECTED EXPENSES

- Management Fee – paid to a third party property management firm and typically a percentage of Net Operating Income. Contact good management firms in your area to determine average cost.
- Payroll & Benefits – on site administrative/management position and a maintenance position may be needed depending on project size. One possible standard is one full time equivalent position for every 80 units. Research employee costs in your area.

PROJECTED EXPENSES

- Maintenance costs – turnover expenses (painting, extermination, cleaning), maintenance of mechanical systems, plumbing and fixtures, minor repairs and grounds upkeep. Typically a percentage of NOI.
- Administrative - office supplies, phone, internet, marketing
- Utilities - trash collection, any unit utilities paid by owner and other property utilities
- Taxes and insurance – actual fixed costs – affordable projects may have a PILOT or other government mechanism to keep taxes low.

REPLACEMENT RESERVES

- First step is to obtain a capital needs assessment which will show the amount likely to be spent each year to replace the property's major systems.
- Can be funded several ways – monthly deposits, from future cash flow or refinancing
- Best practice is to make monthly deposits in an amount that will cover the projected expenses.

OPERATING COSTS PER UNIT

- An additional method of reviewing operating costs is to look at the per unit cost.
- Each state's housing finance agency creates an annual Qualification Allocation Plan with guidelines for items such as per unit operating costs.
- States may also be willing to share data about operating costs of projects in their programs.

DEBT SERVICE

- How much debt can the project support? What is the maximum lenders will loan?
- Review Debt Coverage Ratio (annual cash flow/annual debt service).
- Most lenders want to see a DCR of at least 1.2.
- Your written policies should state what you expect in a DCR and how you respond to a ratio outside of your standard or your standard range.

CASH FLOW AND RETURN ON INVESTMENT

- The cash flow of a project is the amount left after all expenses (including replacement reserves) and debt service are paid.
- PJ must have a policy to ensure that cash flow for a project is neither too low to be able to absorb possible financial shocks during the affordability period nor so high that it is overly compensating the developer/owner.
- Return on investment (ROI) is one way to determine a reasonable cash flow. This is calculated by $\text{annual cash flow} / \text{owner investment}$

SUBSIDY LAYERING (GAP ANALYSIS)

- This is where we determine exactly what the HOME contribution to the project should be.
- Once we're satisfied that the operating pro-forma, including debt service and cash flow to owner is reasonable, we go back to the development budget to determine the "gap" - the difference between total uses of funds and all other sources of funds. That amount will be your HOME funds (keeping all other HOME requirements in mind – subsidy limits, cost allocation)

DOCUMENTING COMPLIANCE

- Each project file must have a written evaluation which demonstrates that the PJ's guidelines have been applied to the project.
- The underwriting and subsidy layering analysis must be signed and dated.
- The written agreement must reflect project underwriting and if changes are made during development, the PJ must update the written agreement and the project file documentation.